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Memorandum for: DDI

This typescript was prepared at the Canadian Desk's request for inclusion in the briefing book being readied for Secretary Shultz in anticipation of his meeting with Canadian External Affairs Minister Clark in Toronto on 15-16 October.



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4 October 1984



Director,

E U R A

**Office of European Analysis
Directorate of Intelligence**

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DIRECTORATE OF INTELLIGENCE

4 October 1984

The Canadian Economy as the Tories Take Over

Summary

Despite two consecutive years of economic growth, Prime Minister Mulroney's Canada is confronted with an unemployment rate hovering around 11.2 percent. In addition, it faces an interest rate of about 13 percent, a budget deficit approaching \$25 billion,* and debt servicing payments consuming a quarter of every tax dollar. Faced with these economic realities -- and his electoral pledge not to cut Canada's comprehensive social welfare system -- we think Mulroney will do little in the short term to change the substance of Liberal economic policy, concentrating instead on keeping Canada's sputtering recovery on track. His only deviations from Liberal policy to date have been the allocation of an additional \$343 million for job creation and an official appeal for foreign investment. If the recovery continues, however, we believe Mulroney in the medium term may accept some of the more conservative economic policies being pressed on him by the Tory right and which he himself probably prefers. These include a reexamination of "universality" in social welfare benefits, reduced business taxes, deregulation of some domestic industries, and a dramatic decrease in federal intervention in the economy. [redacted]

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This paper was prepared by [redacted] Western Europe Division, Office of European Analysis for Secretary of State Shultz's meeting on 15-16 October with Canadian External Affairs Minister Joe Clark. Questions and comments may be referred to [redacted] Chief, Western Europe Division, [redacted]

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*All figures in US \$.

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Economic Prospects

The Canadian economy is headed for a third consecutive year of growth. Fueled primarily by consumer spending -- which should increase by more than 3 percent in both 1984 and 1985 --- and a boom in exports, real GNP probably will rise by 3.5 percent in 1984 and by 2.5 percent in 1985. [redacted]

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The healthy US economy is driving Canada's recovery. Indeed, the contagious vitality of US growth is easing the drag of Canada's high interest rates on domestic economic activity. Signs of recession remain, however, as the recovery is concentrated in such durables as automobiles while demand for nondurables and services remains weak. In addition, private sector capital investment is growing slowly because productive capacity remains in excess and many investors are being lured abroad by still higher rates of return. Following are several economic issues facing the Tories and our estimate of how they may address them.

- Unemployment - The unemployment rate in August was 11.2 percent and we believe it is likely to average 11.3 percent for 1984. A slight improvement is expected in 1985 -- the rate probably falling to between 10 and 11 percent -- but it will not drop into single digits until 1986. In the near term, we believe that Ottawa will do no more than continue to earmark some additional federal funding for job creation. In the medium term, however, we expect it to encourage private sector job creation through tax incentives for business and by facilitating foreign investment.
- Trade - Canada's trade position improved during its recession -- which began later than the US' -- because the earlier US recovery created renewed demand for Canadian raw materials while its imports dropped sharply. Imports now are rising with the recovery, but demand will be moderated by widespread unemployment, high real interest rates, and weak investment in machinery and equipment. US demand for Canadian goods is maintaining Canada's merchandise trade surplus, however, and Canada probably will post current account surpluses of about \$925 million in 1984 and \$310 million in 1985.
- Inflation - The inflation rate declined from 5.8 percent in 1983 to 4.5 percent in 1984. Ottawa remains concerned that inflation might be refueled, but we believe, despite the expected continuing rise in consumer spending, that commodity and energy prices probably will rise only slightly through the next year. In our opinion, inflation will average about 5 percent in 1985.

-- Monetary Policy and Interest Rates - The Bank of Canada (BOC) probably will continue a policy of trade-offs between domestic interest rates and the exchange rate of the Canadian dollar. To date in 1984, the BOC has increased domestic interest rates -- from 10 percent in January to near 13 percent -- in order to limit the decline in the value of the dollar. We expect that the BOC will ease interest rates if it can do so without further depreciating the Canadian dollar which has already fallen from US 80 cents to just under US 76 cents this year. In our opinion, the drop in value of the Canadian dollar probably has bottomed out because of a continuing current account surplus and an improving investment climate, and its steadiness may allow the Bank to reduce interest rates gradually in late 1984 and into 1985. Ultimately, however, the BOC's policy decisions almost certainly will be determined by the level of US interest rates.

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Table 1. Canadian Economic Statistics

	1980	1981	1982	1983	1984	1985*
GNP (billion \$US)	240.2	274.6	288.8	314.8	342.5	368.0
Real Growth (percent)	1.0	3.4	-4.4	3.0	3.5	2.5
Consumer Price Index (1981=100)	88.9	100.0	110.8	117.2	122.5	128.6
Percent Increase	10.1	12.5	10.8	5.8	4.5	5.0
Unemployment (thousands)	867	898	1,305	1,436	1,330	1,300
Unemployment rate (percent)	7.5	7.6	11.0	11.9	11.3	11.0
M1 (billion US\$)	19.8	20.6	20.7	22.9	24.9	26.2
M1 Growth (percent)	6.4	3.8	0.7	10.3	9.0	5.0

*Forecast.

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Table 2. Canadian Current Account

	Billion US\$					
	1979	1980	1981	1982	1983	1984*
Exports						
Merchandise	55.7	65.7	70.2	68.5	73.5	90.4
Services	9.8	12.1	12.7	13.7	13.0	13.5
Transfers	1.7	2.3	2.6	2.6	2.3	2.0
Total	67.2	80.1	85.5	84.8	89.8	105.9
Imports						
Merchandise	52.3	58.4	64.1	53.7	59.2	68.0
Services	18.0	21.4	24.6	27.3	27.6	35.1
Transfers	1.1	1.2	1.3	1.4	1.6	1.9
Total	71.4	81.0	90.0	82.4	88.4	105.0
Balance						
Merchandise	3.4	7.3	6.1	14.8	14.3	22.4
Services	-8.2	-9.3	-11.9	-13.6	-13.6	-21.6
Transfers	.6	1.1	1.3	1.2	0.7	0.1
Total	-4.2	-0.9	-4.5	2.4	1.4	0.9

* Estimate based on First Quarter figures.

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Table 3. Canadian Trade With the United States

	Billion US\$					
	1979	1980	1981	1982	1983	1984*
Exports						
Merchandise	38.1	42.0	46.9	47.3	50.5	63.5
Services	4.7	5.2	5.9	6.0	4.9	6.2
Transfers	0.3	0.4	0.4	0.4	0.3	0.3
Total	43.1	47.6	53.2	53.7	57.7	70.0
Imports						
Merchandise	37.9	40.8	44.0	37.7	38.9	49.3
Services	11.5	13.4	15.3	16.4	16.2	18.2
Transfers	0.3	0.3	0.2	0.2	0.3	0.3
Total	49.7	54.5	59.5	54.3	55.4	67.8
Balance						
Merchandise	0.2	1.2	2.9	9.6	11.6	14.2
Services	-6.8	-8.2	-9.4	-10.4	-11.3	-12.0
Transfers	0.0	0.1	0.2	0.1	0.0	0.0
Total	-6.6	-6.8	-6.3	-0.7	1.8	2.2

*Estimated.

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